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Student Loan Auctions: Issues and Implications

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Student Loan Auctions: Issues and Implications

Executive Summary

Background. Representatives of the financial aid community are exploring options for using an auction system or other market-based mechanisms to determine interest rates and subsidy levels for federal education loans. Their congressionally mandated goal is to evaluate whether a market-based model could reduce the cost of loans to students, parents, and taxpayers and, at the same time, maintain high-quality services for *all* borrowers and schools.

The findings of the task force could fundamentally alter the delivery of federal education loans, which are now the nation's single largest source of financial aid. During the 1999-2000 academic year, federal loans are expected to reach a record $36 billion, including $24 billion in guaranteed loans issued by private lenders under the Federal Family Education Loan Program (FFELP). Nationwide, lenders will issue more than 5 million loans each averaging in excess of $3,500 to students attending thousands of schools ranging from community colleges to exclusive private institutions to small vocational schools to huge state universities.

Congressional interest in an auction system stems from a desire to reduce the federal subsidy to the loan program and thus help shrink federal budgetary outlays. Some lawmakers contend that an auction will spur lenders to lower the cost of loans to students. An added bonus is eliminating the political headache created when Congress tries to dictate interest rate formulas from Capitol Hill. Lawmakers mandated the auction study in as part of the Higher Education Amendments of 1998.[1] This legislation authorized the continuation of the Higher Education Act, which established the federal loan program in 1965. The amendments included a revision in the formulas used to set interest rates for Stafford loans for students and PLUS loans for parents. Without the change, a rate formula scheduled to take effect in July 1998 was expected to drive virtually all lenders out of the federal loan program.

Objectives of the Auction Study. According to the conference report for the 1998 HEA legislation, the Comptroller General and the Secretary of Education are required to appoint a study group "to identify and evaluate means of establishing a market mechanism for the delivery of Title IV loans." The legislation stipulates that at least three different mechanisms must be proposed and analyzed. The group is to submit its preliminary findings by mid-November 2000 and file its final report no later than May 15, 2001.

Congress did not specify the market mechanisms to be studied but did establish at least a dozen criteria to be used in the evaluation. These include how such mechanisms would affect the following: interest costs borne by student and parent borrowers; the federal budget; the distribution of federal subsidies to loan providers; the regulatory burden for students, institutions, lenders, and other program participants; efforts to reduce student loan defaults; and the market incentives needed to encourage improvements in service quality.

[1] Public Law 105-244.

Congress also required the study group to be representative of lenders, other participants in the federal loan programs, financial service providers, and the financial aid community.

Objectives of the Federal Loan Program. The evaluation criteria stated above clearly indicate that Congress intends to determine whether a market-based mechanism can increase the efficiency of Stafford and PLUS loans *without* sacrificing four key policy goals that form the cornerstone of the federal education loan program today. These goals are as follows:

1) **Provide universal access to higher education by ensuring that any eligible student is able to obtain a federal education loan, regardless of the borrower's socio-economic status or choice of school.**

2) **Make federal loans available at the lowest possible cost to borrowers.**

3) **Protect taxpayers' fiscal interest by minimizing the cost of default.**

4) **Improve the student loan delivery system by simplifying the loan process; reducing paperwork and regulatory burdens on students, parents, schools, loan providers; and encouraging high-quality customer service.**

Existing Auction Models. Several federal agencies use auctions to sell assets or the rights to provide products and services to consumers. The best known auction of financial assets is probably the Treasury Department's sale of Treasury bills. Military surplus, real estate, and a variety of consumer goods, including personal property seized by law enforcement agencies are sold to the public via auction. Washington uses a variety of bidding processes to sell the *rights* to cut timber, sell infant formula, extract oil from petroleum reserves, and provide wireless communication services. Only a few agencies have used auctions to sell loans or the right to make loans. The Department of Housing and Urban Development, for example, has auctioned defaulted mortgages, and the Department of Health and Human Services (HHS) held auctions to select lenders under the Health Education Assistance Loan (HEAL) program.[2]

The HEAL Auction Experiment. The HEAL loan auction is sometimes offered as a model for a FFELP auction. In 1992, lenders began competing under a single-round auction process to win the right to make loans to students pursuing degrees in 11 different health professions. The performance review of the HEAL auction is mixed. Although the auction generated a steady downward trend in HEAL rates, annual shifts in the roster of winning bidders for new HEAL loans forced many, if not most, medical schools to withdraw from the HEAL program.

FFELP Auction Options. Just how would a FFELP auction work? Industry analysts have offered numerous possibilities, but most are variations of a type of auction known as a rights auction. Bidders, for example, could be invited to bid on the right or rights to make a specified amount of loans to a particular group of borrowers during a particular time frame at a pre-determined price. A key issue is how to establish a system that guarantees ready access to loan funds by borrowers, regardless of the type of institution they attend or where they reside, and, at the same time, lowers the subsidy cost to taxpayers. Would a sufficient number of lenders be willing to supply loans to high-default proprietary schools

[2] "Competitive Financing Mechanisms: Auctions Used by Federal Agencies" was published in a letter to members of the House Education and Workforce Committee. GAO document citation: *GAO/HEHS-99-57R Federal Auctions.*

that serve economically disadvantaged students? If the auction process radically reduces the number of players to just a few big lenders, would they be able to originate loans anywhere in the U.S.? At present, no one lender truly markets nationwide. Another key issue: Can an auction process offer sufficient incentives to ensure a high level of service quality and investment in technology needed to improve service delivery?

Another possibility would be an auction of the actual loans. This option is mentioned because it would provide a mechanism to mesh the Federal Direct Loan Program (FDLP) with the FFELP. In the FDLP, the Department of Education is the lender and holder of loans. Under an auction model, the government could sell these loans to lenders, secondary markets or other private entities either prospectively or after the loans are made. Some analysts have suggested that FFELP loans could be originated by a single entity—presumably the Department of Education—but then auctioned to the highest bidders, which would then be responsible for servicing the loans and bearing default costs. Would-be purchasers would factor the future cost of funds, servicing expenses and default losses into their bids. Although this approach could simplify the loan origination process, it could also result in shifts in loan servicing arrangements. In addition, the government is not guaranteed that it could receive an acceptable price, especially if only a few lenders or secondary markets submit bids.

Both rights auctions and loan auctions are deceptively simple in concept. In practice, both models require complex structures that must address numerous policy concerns and operational issues, including the frequency of auctions, bidding procedures, and bidder eligibility rules. The full report provides a guide to key structural components of both types of auction models.

Long-Term Implications of a Student Loan Auction. Clearly, an auction process might help lower the cost of federal education loans over the short-term. Long-term, however, an auction approach is likely to reduce the number of market participants, since losing bidders may decide to quit the business permanently. The resulting exodus of bidders and turnover in loan providers could quickly erode the quality of services to borrowers and schools.

A decline in the number of market players will eventually reduce the competitiveness of the auction. Fewer players mean bigger players, raising the costs and stakes of trying to enter or re-enter the market. As the number of bidders dwindles, so does the pressure to hold the line on costs and lender-yield requirements. The remaining bidders would have little incentive to improve service quality or invest in new technologies. Eventually, borrowers could pay higher rates and taxpayers higher subsidies for stagnating service levels.

Moreover, auctions are likely to disrupt the student loan delivery system. Losing bidders could be abruptly shut out of the program. Such dislocations force borrowers and schools to locate new sources of funds. Change would be the result of shifting lender relationships rather than innovation. Although measures could be implemented to increase the number of bidders or enhance loan terms, such steps tend to increase program costs and complexity and thus undercut the benefits of an auction pricing system.

The FFELP: A Market-Driven Alternative to Auctions? Most advocates of student loan auctions contend that the current guaranteed loan program is not "market-based" and that only an auction would establish a truly fair price for the government to pay to induce lenders to make loans. Yet, today's FFELP lenders vigorously compete for student loan volume.

By most accounts, lender competition based on service became fierce at least 10 years ago, well before the enactment of the Federal Direct Loan Program in 1993. During this period, FFELP loan providers developed and implemented continuous improvements in loan delivery systems and servicing standards, notwithstanding the absence of any federal requirement to do so. For example, millions of dollars have been invested in sophisticated automated account inquiry services borrowers can access via telephone or the Internet. The Web sites of lenders, loan servicers and guarantors offer dozens of calculators and other interactive counseling resources. Over the last five years, lenders intensified their efforts to win customers by increasing the focus on price. Today, competition based on the cost of loans to borrowers is virtually universal. Clearly, students and parent borrowers are the primary beneficiaries of these free-market initiatives, and a recent government survey shows that the FFELP is enjoying strong gains in customer satisfaction among schools and borrowers.[3]

Conclusion. In general, the myriad questions voiced regarding the structure and outcomes of student loan auctions focus on how to protect the interests of schools, students, borrowers, and taxpayers and foster competition. Policymakers can choose among dozens of alternative auction concepts for structuring the bidding process, including models designed to address school concerns about retaining lender choice. Still, in many instances, addressing auction implementation issues would require the development of special rules and procedures or the creation of a management/oversight function within the U.S. Department of Education. As policymakers and Congress consider the issues, they should ask whether the negatives associated with an auctionXincreased complexity, abrupt changes in loan providers, and eventual deterioration in competition with subsequent deterioration in price and service levelsXoutweigh the benefits.

Thus, any serious consideration of "market-based mechanisms" must start with a disciplined examination of the policy goals that underpin the federal student loan programs. The study group should not only evaluate new market-mechanisms against these objectives, but also should assess the current guaranteed loan program's track record in achieving national policy goals. This discovery process could demonstrate that more could be lost than gained by a precipitous move to an auction system that radically alters the diverse incentive structure that drives FFELP loan providers to serve all eligible borrowers at ever increasing levels of service and price benefits.

[3] "Direct Loan Program Administration, 1993-1998," Macro International, under contract to the U.S. Department of Education..

Student Loan Auctions: Issues and Implications

Introduction

Representatives of the financial aid community are exploring options for using an auction system or other market-based mechanisms to determine interest rates and subsidy levels for federal education loans. Their congressional mandate is to evaluate whether a new means of determining lender return on student loans should be adopted. The group will examine at least three different "market mechanisms" that are conducive to advancing the basic objectives of the program, including the availability of loans for all eligible students.

The study is required under the Higher Education Amendments of 1998.[4] It was included in the legislation following a lengthy debate on how to minimize the cost of loans to borrowers without incurring unnecessary federal subsidies. Congress approved the study after rejecting a proposal to test one or more auction mechanisms on a limited basis, under a pilot project, and after a lengthy and sometimes heated debate on the appropriate level of the federal payments made to lenders under the FFELP.

If adopted into law, the findings of the task force could fundamentally alter how students obtain federal student loans and how education loans are administered on campus. Student loans are now the nation's single largest source of financial aid for higher education. During the 1999-2000 academic year, federal loans are expected to reach a record $36 billion, including $24 billion in guaranteed loans issued by private lenders under the Federal Family Education Loan Program (FFELP). Nationwide, lenders will issue more than 5 million loans, each averaging in excess of $3,500 to students attending thousands of schools, ranging from community colleges to small vocational schools to exclusive private institutions to huge state universities.

In light of the study's importance, members of the higher education community are expected to participate actively in the task force deliberations and the drafting of recommendations. This paper is intended to identify some of the central issues involved in implementing one of the market-based mechanisms the group is expected to examine: **student loan auctions**.

Background

Congressional interest in an auction system stems from lawmakers' desire to provide students and other borrowers with the least costly loans possible and, at the same time, ensure universal availability and high-quality service to students, borrowers, and schools. The three objectives—optimal cost, availability, and service—have been and remain somewhat in conflict with each other. Low-cost student loans have traditionally required substantial federal subsidies to borrowers and loan providers (in the guaranteed student loan program). Assuring universal availability of loans and high service levels requires considerable investment in human and capital resources. The study group's mandate, in essence, is to determine whether the market mechanisms currently used to establish price and service levels in the student loan program could be changed to reduce costs to the government while continuing to serve all eligible students.

[4] Public Law 105-244.

Some lawmakers contend that an auction will spur lenders to lower the cost of loans to students. Others believe an auction would somehow "simplify" the student loan programs. Still others expressed an interest in an auction as a means of ending the periodic political headaches that arise when Congress tries to dictate interest rate formulas from Capitol Hill.

The decision to conduct the market-mechanisms study reflects, in part, the frustration of Congress created by the budget and policy challenges involved in addressing FFELP interest rate and lender return issues during the 1998 reauthorization of the Higher Education Act. One of the greatest challenges facing Congress in 1998 was finding a way to modify the interest rate formula to reduce the cost of the guaranteed loan program, yet, still provide sufficient lender yields to assure the continued availability of loans after July 1, 1998. Under legislation enacted in 1993, the base rate used to calculate federal loan rates was scheduled to change in mid-1998, from a short-term Treasury bill index to a long-term government bond index. Providers of guaranteed student loans argued that the economic impact of this change would make their continued participation in the program impossible.

In exploring solutions to this problem, lawmakers faced significant budget constraints. Under the Congressional Budget Act, projected expenditures for student loans were strictly limited. Because prevailing financing conditions made amending the formula for lender returns costly, Congressional frustrations ran high. Bipartisan efforts in both the House and Senate to simultaneously reduce the cost of loans to borrowers below the levels then in effect compounded the difficulty.

Efforts to resolve the issue were structured to provide student loan borrowers with the same level of interest rates expected to take effect under the scheduled change in the rate formula. To achieve this goal within the limits set under the Budget Act, federal payments to guaranteed loan providers would have to be minimized. Throughout the debate, lawmakers bemoaned the inherent difficulty in determining a "fair-market" return for lenders, as noted in the following excerpt from a February 1999 report published by the General Accounting Office:

> Throughout the history of the FFELP, and especially over the past year, debate over [the rate] formula has centered on whether lenders' profits have been excessive—at the expense of college students, their families, and taxpayers. Lenders have claimed that recent proposals to reduce the interest rate they receive would force them to end their participation in the FFELP. Studies by the Department of the Treasury, the Congressional Budget Office (CBO), and the Congressional Research Service (CRS) have reached differing conclusions about the extent to which lenders could bear a reduction in their interest rate and still continue to earn reasonable profits. As a more recent CBO study noted, the federal government lacks information regarding the costs FFELP lenders incur through their participation. Consequently, the current rate-setting formula may result in some lenders earning higher profits than necessary to secure their participation. However, if the government were to make a significant cut in the lenders' rate and some lenders decided not to participate in the program, the supply of loans might be reduced, perhaps to the point of being insufficient to satisfy the borrowing desired by students.[5]

The 1998 reauthorization process concluded with the enactment of the Higher Education Amendments of 1998, which authorized the continuation of the two major student loan

[5] "Competitive Financing Mechanisms: Auctions Used by Federal Agencies" was published in a letter to members of the House Education and Workforce Committee. GAO document citation: *GAO/HEHS-99-57R Federal Auctions*.

programs administered by the U.S. Department of Education for the next five years. In this legislation, Congress addressed the immediate lender return issue by extending the then-current provisions—and reducing the subsidy to lenders—through June 30, 2003. Congress also mandated the market-mechanisms study. The results of the study may help guide Congress in designing a new mechanism for determining lender yield when lawmakers address what some policy analysts have already dubbed the "2003 Interest Rate Problem." A brief history of recent changes in Stafford and PLUS loan interest rates is provided beginning on page 25.

Objectives of "Study of Market Mechanisms in Federal Student Loan Programs"

Under section 801 of the Higher Education Act, the Comptroller General and the Secretary of Education are required to convene a study group "to identify and evaluate means of establishing a market mechanism for the delivery of Title IV loans." The legislation stipulates that at least three different mechanisms must be proposed and analyzed. The group must submit its preliminary findings by mid-November 2000 and file its final report no later than May 15, 2001.

Congress did not specify the market mechanisms to be studied but did establish the following criteria to be used in the evaluation:

1) The cost or savings of loans to or for borrowers, including parent borrowers.

2) The cost or savings of the mechanism to the federal government.

3) The cost, effect, and distribution of federal subsidies to or for participants in the program.

4) The ability of the mechanism to accommodate the potential distribution of subsidies to students through an income-contingent repayment option.

5) The effect on the simplicity of the program, including the effect of the plan on the regulatory burden on students, institutions, lenders, and other program participants.

6) The effect on investment in human capital and resources, loan servicing capability, and the quality of service to the borrower.

7) The effect on the diversity of lenders, including community-based lenders, originating and secondary market lenders.

8) The effect on program integrity.

9) The degree to which the mechanism will provide market incentives to encourage continuous improvement in the delivery and servicing of loans.

10) The availability of loans to students by region, income level, and by categories of institutions.

11) The proposed federal and state role in the operation of the mechanism.

12) A description of how the mechanism will be administered and operated.

13) Transition procedures, including the effect on loan availability during a transition period.

14) Any other areas the study group may include.

Congress also required the study group to encompass representatives of lenders, other participants in the federal loan programs, financial service providers, and the financial aid community.

Objectives of the Federal Loan Program

The study group is directed to identify no fewer than three different market mechanisms for determining lender return "while continuing to meet the other objectives" of the student loan programs. The mandate for the study does not specify what these objectives are. Within the higher education community, these objectives are widely seen as including the following:

1) **Providing universal access to higher education by ensuring that any eligible student is able to obtain a federal education loan, regardless of the borrower's socio-economic status or choice of school.**

2) **Making federal loans available at the lowest possible cost to borrowers.**

3) **Protecting taxpayers' fiscal interest by minimizing the cost of defaults.**

4) **Improving the student loan delivery system by simplifying the loan origination and repayment process; reducing paperwork and regulatory burdens on students, parents, schools, and loan providers; and ensuring high quality customer service.**

Universal access. The most constant objective of the federal student loan programs since the original enactment of the Higher Education Act in 1965 has been to assure that every eligible student, as defined by Congress, has access to student loans. Congress has defined borrower eligibility broadly. The definition now encompasses students attending traditional four-year colleges and universities, as well as students enrolled in short-term courses at career, junior, and community colleges. Moreover, Congress recently recognized the increasingly important role of the Internet in delivering higher education, by expanding the definition of eligibility, on a pilot basis, to students enrolled in distance-education programs.

Consistent with the universal availability of loans is the companion objective of ensuring similar loan terms for all students. Notwithstanding significant differences between the types of borrowers receiving loans, borrowers have received the same repayment terms, interest rates, and deferments. In a given financial aid award year, for example, a student enrolled in a truck-driving school in a rural community pays the same interest rate as a student pursuing a professional degree at an Ivy League university.

Many believe Congress is unlikely to favor a system that establishes different rate terms for different categories of students. Multiple rate structures could result if, under a student loan auction, lenders are allowed to bid a lower rate for students attending low-default schools, which typically are four-year universities or graduate schools, and higher rates for students attending high-default schools.

The goal of universal access entails more than simply making loans available on demand. Lawmakers have generally insisted, too, that borrowers enjoy the freedom to select their lenders. Continuity of access is also important. Borrowers generally want to obtain all of their education loans from the same lender, thus centralizing their accounts and minimizing paperwork hassles.

Minimizing cost to borrowers. Over the years, Congress has made a series of adjustments in student loan interest rates to minimize costs to borrowers, while still maintaining lender participation. (See rate history on page 25). Lawmakers also aided students by outlawing prepayment penalties and by limiting the frequency of interest capitalization. Still, the lender's return has always been part of the interest rate equation. To promote widespread lender participation, Congress has adjusted subsidies to ensure that lenders receive a sufficient market return.

On some occasions, Congress actually increased the cost of student loans when pressured to do so under fiscal budget procedures. One such instance occurred in 1981, with the enactment of borrower-paid loan origination fees. History shows, too, that Congress has reversed increases in the cost of loans when budgetary conditions permitted doing so. Indeed, strong bipartisan support for reducing the cost of student loans was a major theme of the debates surrounding 1998 reauthorization of the Higher Education. As a result, the final provisions of the 1998 reauthorization produced some of the lowest borrower loan costs in recent years.

Minimizing default costs. Defending against defaults is deemed critical to maintaining the integrity of the federal loan programs. Although student loans are expected to experience higher default rates than other consumer loans, default costs must be controlled to keep the program's costs manageable. In the late 1980s, soaring default rates, coupled with skyrocketing loan volume, prompted a crackdown on fraud and abuse. Anti-default measures enacted by Congress include termination of federal loan eligibility for schools that experience high cohort default rates over a three-year period.

Since the early 1990s, the national default rate on guaranteed loans has been cut by more than 60 percent—to less than 9 percent. Many industry observers credit much of this reduction to default avoidance programs instituted by guarantors and other loan providers. Significant improvements in loan servicing systems, which today are likely to include instant, on-line access to borrower account information as well as interactive counseling resources, are also credited with helping to reduce default rates. The evaluation criteria for the study group include both the "effect on program integrity" and "the degree to which the mechanism will provide market incentives to encourage continuous improvement in the delivery and servicing of loans." Both may be considered relevant to the objective of minimizing default costs.

Enhancing service delivery and quality. This policy objective can be viewed, in part, as a reaction to the rule-laden complexity of the current federal loan programs. A patchwork of major and minor legislative changes have been enacted over the course of 35 years to expand student and school eligibility, liberalize repayment terms, defend the program against fraud and abuse, protect borrowers' rights, and reduce defaults by imposing sanctions against borrowers, schools and lenders. As a result, issuing and servicing student loans is more complicated than administering other types of consumer credit.

In recent years, lawmakers have explored ways to simplify the student loan program to ease regulatory burdens on schools and loan providers, and to make it easier for students

to manage their growing student debt burdens. For example, among the steps taken by Congress in the 1998 reauthorization was a directive to modernize the Department of Education's Office of Student Financial Assistance and the data systems used to support the federal student aid programs. Not surprisingly, one of the study group's criteria for evaluating market-based mechanisms is their "effect on the simplicity of the program."

The study group must also evaluate the effect of market-based mechanisms on present and future investments in "human capital and resources, loan servicing capability, and quality of service to the borrower." Clearly, Congress recognizes that improvements in the delivery and quality of education loan services depends on the ability of loan providers to enhance delivery systems by investing in new technologies and by attracting competent, well-trained employees.

Existing Auction Models Used by the Federal Government

Several federal agencies currently use auctions to sell assets or the rights to provide products and services to consumers. The best known auction of financial assets is probably the Treasury Department's weekly sale of Treasury bills. Military surplus, real estate, and a variety of consumer goods, including personal property seized by law enforcement agencies, are sold to the public via auction. In addition, Washington employs a variety of bidding processes to sell the *rights* to cut timber, sell infant formula, extract oil from petroleum reserves, and provide wireless communication services.

According to the February 1999 GAO report, only a few agencies have used auctions to sell loans or the right to make loans. The Department of Housing and Urban Development, for example, has auctioned defaulted mortgages, and the Department of Health and Human Services (HHS) held auctions to select lenders that could issue loans under the Health Education Assistance Loan (HEAL) program.[6] Most recently, the Small Business Administration has proposed using an auction in connection with loans administered by the agency.

The HEAL auction experiment. The most frequently cited example of how an auction mechanism might work in the federal student loan programs is the HEAL loan auction implemented by HHS. In 1992, lenders began competing under a single-round auction process to win the right to make loans to students pursuing degrees in 11 specified health professions. Lenders could bid for the right to make loans for all or a portion of a particular discipline (medicine, veterinary medicine, etc.). Lenders could also bid for the right to make loans in a particular state or to students attending a specific school. Lenders submitted sealed bids stating the interest rates they would charge while borrowers were in school, deferment, grace, or repayment.[7]

The performance review of the HEAL auction is mixed. Although the auction generated a steady downward trend in HEAL rates, annual shifts in the roster of winning bidders for new HEAL loans forced many, if not most, health-professions schools to withdraw from the HEAL program. Medical schools found themselves constantly having to alter their loan delivery systems to accommodate the change in lenders. A constantly shifting mix of lenders requires system changes, and thus extra expenditures of time and money. Financial aid administrators worry, too, that frequent shifts in lenders could undermine default prevention efforts, noting that borrowers had trouble tracking how much they owed

[6] *GAO/HEHS-99-57R Federal Auctions*.

[7] *GAO/HEHS-99-57R Federal Auctions*.

and to whom. Indeed, some industry observers note that perhaps the only reason the HEAL auction process worked at all is that more than 80 percent of HEAL loans were purchased by a single secondary market, preventing many borrowers' loans from being split among multiple loan servicers.

The limited experience of the HHS program makes it difficult to determine whether the HEAL auction process could be successfully applied to the FFELP. The HEAL auction lasted only a half-dozen years. Largely because the HEAL program suffered heavier-than-expected default costs (although HEAL default rates are substantially lower than Stafford default rates), Congress began a phase-out of the HEAL program in 1996. Since then, new HEAL loans could be issued only to existing HEAL borrowers. To offset the demise of HEAL, Stafford loan limits were increased substantially for students in health professions.

Moreover, the scope of the HEAL program pales in comparison to the FFELP. During the auction years, the annual HEAL volume never totaled more than $500 million dollars, borrowed by a few thousand students attending several hundred schools. HEAL providers are limited to a handful of lenders and just two servicers. In contrast, each year, the FFELP program makes more than $20 billion in loans to approximately 4 million borrowers enrolled at 6,000 institutions.

Congressional Budget Office analysis. A Congressional Budget Office (CBO) research effort may identify possible auction models for examination by the study group. The purpose of the CBO research paper, according to the request made by Senate Budget Committee Pete Domenici (R-NM), is to identify the pros and cons of at least three basic market mechanisms, of which at least one is expected to be an auction. The CBO paper will not recommend a particular form of auction or other mechanism.

FFELP Auction Options

Rights auctions. Industry analysts have offered numerous possibilities that reflect differing views of how the auction could or should alter the structure of the student loan programs. One of the most commonly cited models is known as a "rights" auction. Just how would a FFELP rights auction work? Stated most simply, under a rights auction, bidders would compete for the right to make loans on the basis of criteria specified by the auction authority, presumably the Department of Education. Rights allocation criteria could include the cost of loans to borrowers, the cost to the taxpayer, other criteria, or a combination of criteria. Bidders, for example, could be invited to bid on the right or rights to make a specified amount of loans to a particular group of borrowers during a designated time frame at a pre-determined price.

A key issue in a rights auction is how to establish a system that guarantees ready access to loan funds by borrowers, regardless of the type of institution they attend or where they reside, and, at the same time, lower the subsidy cost to taxpayers and preserve service quality. As the questions in the accompanying box indicate, fashioning an auction mechanism to achieve this goal will not be easy. Some winning bidders, for example, may attempt to maximize loan portfolio yields by targeting their loan allocation to low-default, four-year institutions and graduate schools. Other lenders may desire to limit lending to a particular state or geographic area, making the goal of universal availability of loans more difficult to achieve. A rights auction may take one of many forms. The potential features of rights auctions are explored in greater detail later in this paper.

Key Questions about Rights Auctions

Would a sufficient number of lenders be willing to supply loans to high-default schools?

Would a rights auction provide sufficient incentive to loan providers to improve or even maintain service quality?

Would smaller loan providers be able to participate effectively, given the increased uncertainties inherent in the rights auction model?

If the auction process radically reduces the number of loan providers to just a few big lenders, would these be able to originate loans anywhere in the U.S.?

Would the imposition of new requirements on loan providers increase the complexity of the program or create new integrity issues?

What is the long-term impact on borrowers and their ability and willingness to repay their loans?

Loan auctions. Instead of selling loan origination rights, the federal government could auction existing portfolios of loans. This option is often identified as a mechanism to mesh the Federal Direct Loan Program (FDLP) with the FFELP. Under direct lending, the Department of Education is the lender and holder of loans. Under a loan auction, the government could sell these loans to lenders, secondary markets, or other private entities after the loans are made.

Some analysts suggest that FFELP loans could be originated by a single entity—presumably the Department of Education—and then could be auctioned to the highest bidder or bidders, which would then be responsible for servicing the loans and bearing default costs. Would-be purchasers would factor the future cost of funds, servicing expenses, and default losses into their bids. Others speculate that the federal government could bundle packages of loans into securities and auction the securities. All administrative aspects of the loans under such an auction would be determined in advance by the Department of Education. Any winning bidder would, in essence, be a passive investor in the loans.

In addition to shifting the delivery process to a single originator—presumably a government contractor—a loan auction could result in basic shifts in how student loans are serviced. Some industry observers believe an auction would result in lower quality servicing at a time when borrower satisfaction with current servicing arrangements is at an all-time high.

A final consideration relates to the impact on the cost of the loan programs to the federal government. There is no guarantee that a loan auction would reduce federal costs. Arguably, the federal government could elect to keep the loans on the government's books as federal assets if the bidding process did not produce an acceptable price, but only if Washington is willing to fund the student loan portfolio through the end of repayment. Under the current guaranteed loan program, loan providers value the

development of relationships with borrowers. In many instances, these relationships serve as the foundation for the marketing of additional services. The advantages of the current program would change in a loan auction.

Policy analysts have suggested a variety of loan auction models. Key aspects of selling existing loan portfolios are discussed in the section that begins on page 18.

Key Questions about Loan Auctions

Would loans sold by the government carry a federal guarantee against default?

Who would be responsible for providing default prevention activities?

Would the auction terms stipulate repayment terms and conditions, such as length of repayment period and borrower benefits?

How would a loan auction affect service quality and innovation?

What would happen if the government failed to receive enough acceptable bids?

Features of Rights Auctions

As noted above, multiple variations on the basic rights auction model are possible. This section briefly discusses 10 possible features of a student loan rights auction and their potential impact on the student loan delivery system. The list is not a comprehensive one but does cover issues that are central to the implementation of an auction program and the management of the risks that are inherent in using a bidding process to allocate loan origination rights.

1) **The nature of the rights sold.** The right to make student loans could be auctioned in dozens of different ways. Options include:

   - Rights to make loans to any eligible borrower.
   - Rights to make loans based on the type of borrower (student vs. parent, undergraduate vs. graduate student).
   - Rights to make loans based on presumed loan quality, as reflected in institutional cohort default rates or average borrowing levels for students attending the institution.
   - Rights to make loans based on the type of institution the borrower attends (community college, proprietary school, four-year colleges, research universities, graduate schools).
   - Rights to make loans in specific geographic areas, such as states or regions.

Rights could be tied to the location of the borrower's school or the borrower's state of residence or could be based on the risk profile posed by various categories of loans, such as those deemed highly vulnerable to default.

Some argue that allocating loan-origination rights on a regional or state basis could help rationalize the process for ensuring nationwide access. The winning lender or lenders for a given area would have to make loans to all comers, regardless of the type of institution attended by the borrowers. Nationwide loan providers are likely to oppose this approach.

Based on the experience of the HEAL auction program, local or regional lenders and secondary markets, particularly those with tax-advantaged sources of capital, can be expected to bid aggressively to claim their territories and thus assure future business. Aggressive bidding that results in widely different federal costs on a region-by-region or school-by-school basis would cause dissension among schools. Members of Congress are not likely to approve an auction system that would result in higher subsidy rates for some states than for others.

As noted above, bidders could be invited to bid on different portfolios, based on loan quality. This could be achieved by setting different subsidy rates for different levels of loan quality. In one model, participants would submit bids for one or more of several tiers of loan quality—for example, schools with default rates of less than 5 percent, schools with default rates of 5 to 10 percent, schools with default rates of 10 to 15 percent, and schools with rates of 15 percent or higher. Schools with persistently high default rates (25 percent or more) would be forced to leave the program. Guarantors and other designated lenders of last resort would be called upon to make loans to students in default categories that do not attract bidders. In the loan auction model, an appropriate role for the Department of Education would be to serve as the lender of last resort.

Finally, bidders could be granted the right to make loans only in a particular year or to make all of the loans issued to a particular borrower. The first approach is simple but could prove disruptive to borrowers and financial aid administrators who find themselves dealing with a new lender every year. A revolving door of lenders will confuse borrowers and could trigger a continuous stream of processing upheavals in the financial aid office. Then, too, this type of rights auction could disrupt the ongoing implementation of the Master Promissory Note (MPN), which was developed to reduce paperwork hassles and encourage serial borrowing. The second approach—granting serial borrowing rights—could ease the loan process for borrowers but could simultaneously restrict their ability to choose their lenders.

2) **Bid pricing terms.** Bids in a student loan auction need not be made exclusively on the basis of bidder payments to or from the government. Participants could submit bids based on their minimum lender yields or on a combination of terms, including the interest rates paid by borrowers, up-front fees, and repayment terms. This method is used by the HEAL program. Basing bids on repayment terms would provide a method for granting a different interest subsidy rate for loans that are repaid under an income contingent repayment plan. In addition, lenders would have an incentive to develop innovative repayment strategies and offer interest rate discounts or other rewards for on-time payments.

Although the specification of bid-pricing terms provides an opportunity to promote innovation, incorporating unfamiliar or complicated terms could discourage smaller

lenders from participating in the program. A highly complex mechanism may require an equally complex evaluation method and would likely engender protests by losing bidders.

3) **The frequency of the auctions.** Many presume student loan auctions would be held annually. However, there is no inherent reason that would require yearly sales. Auctions could be held as frequently or infrequently as necessary to assure the availability of loans to borrowers and their families. Yet, there are pros and cons to every basic approach to the timing of rights auctions. For example, a major risk of annual auctions is the potential lack of continuity, not only for schools but also for lenders. Borrowers and schools do not want to deal with an ever-changing cast of loan providers, as could be the case under an annual auction process.

   Some contend that holding auctions every five years rather than on an annual basis could help meet two key goals: continuity of service and continued investment in product delivery. A longer-term auction process, it is argued, would help satisfy serial borrowing needs of borrowers and schools; the latter do not want to constantly change their systems for receiving loan funds. Lenders and other players are also more likely to stay in the game and invest in service enhancements. Lenders are unlikely to improve service if they perceive an unacceptable risk of being eliminated in the next auction. However, long-term auctions could introduce an unacceptable level of interest rate risk, depending on the type of rate index used to bid the subsidy.

   Others believe that infrequent auctions would simply result in the permanent elimination of those loan providers that lose out in the initial auctions. New sources of capital or loan providers offering innovative new loan delivery mechanisms could be frozen out of the process. Furthermore, the federal government would not benefit from administrative cost reductions that could be achieved through the adoption of new technologies that would, in turn, foster more competitive bidding.

4) **The volume of loan rights sold.** A key question posed by the loan auction model is how much student loan volume would be scheduled for sale. Some suggest that the government could sell an entire year's volume in one session. Others contend that the loan rights allocations should be distributed over a series of auctions, permitting adjustments to be made on an on-going basis.

   One potential complication to a multi-stage auction process is assuring that borrowers are able to receive all of their loans from a single loan provider. Serial borrowing is a goal shared throughout the student loan community. Thus, most models of a rights auction stipulate that, once a lender wins the right to make loans to a borrower, the lender would gain the right to make any and all subsequent loans to the borrower. Unfortunately, including serial loans with the right to make the initial loan makes it more difficult for lenders to price their bids and for the government to evaluate the offers.

   Some suggest that the auctions allocate only one-third to one-quarter of each year's anticipated new volume—for example, the portion of new loan volume that goes to first-time borrowers. The winning bidders would also gain the right to make subsequent loans to those borrowers. This approach could help minimize disruptions in loan providers and help preserve serial borrowing but, again, would significantly complicate the auction process. Even so, depending on the geographic distribution of winning bids, a staggered-volume auction could prove problematic in ensuring the availability of funds to every borrower in every state.

Most models of rights auctions envision Washington selling more loan capacity rights than students and parents would actually need. This could help ensure sufficient participation and competition by lenders. For example, if the program needs $30 billion in annual loan capacity, the government could accept bids to cover $60 to $90 billion. Lenders would then compete with each other in the market, but their individual loan volumes could not exceed their auction quotas.

The auctioning of rights in excess of envisioned demand, while helping to assure borrower access to loans, could create additional program complications in the form of compensation to lenders for unused auction rights. Related to this potential problem is the question of whether successful bidders would be authorized to sell rights to other holders, creating, in essence, a secondary market in student loan rights.

5) **Limits on individual bids.** A major challenge of the auction concept is how to maintain a fair and open bidding process. Among the key issues are whether a single capital provider should be allowed to successfully bid the entire volume of loans auctioned each year or whether a maximum limit should be placed on the volume won by a single entity.

   Participants in the auction could be limited to bids that are a given percentage over their current market share; for example, a lender with 8 percent of the market could bid for no more than 10 percent of new loan volume in a specified time frame. Alternatively, there could be overall limits on market share bids or allocations; that is, no one bidder could receive more than a set percentage of the volume. In the latter case, the auction process could favor existing loan providers, effectively frustrating the goal of some to attract new capital providers to the student loan market.

   Another concern relates to differences in the cost of funds currently enjoyed by some loan providers. An auction system that allocates market share strictly on the basis of price will favor the players that enjoy the lowest cost of funds—that is, the largest banks and tax-advantaged players, such as tax-exempt secondary markets. Because the market is already concentrated among a small number of large banks, several auction rounds could effectively eliminate all but a few lenders. This approach, thus, would limit school choice.

   One solution to this problem is to set aside a small volume of loan rights to financial institutions below a specified size. This so-called “small lender set-aside” would assure that at least some smaller lenders would remain in the student loan program. Some have criticized this suggestion, noting that it would essentially guarantee that the federal government would pay higher subsidies than necessary, at least to some lenders.

6) **Penalties.** A key issue in a rights auction is how to police the subsequent actions of lenders to assure that rights are awarded according to any stipulated terms and conditions. For example, in a general auction of loan rights, lenders may be required to make loans to any eligible borrower. If a lender chooses to maximize the return on the student loan portfolio by marketing only to high-cost, low-default rate schools, would that lender be in violation of the regulations governing the auction?

   To address the access issue and similar problems, the auction system could include penalties for lenders that do not make required use of their market allocation or otherwise violate the terms of their awards. For example, if a lender receives a $500 million loan rights allocation but uses that allocation to make only $200 million in

loans, the lender's rate subsidy could be reduced. This approach would help prevent the supply of available loans from falling short of demand. Conversely, penalties could be imposed on lenders that exceed their quotas.

It is highly likely that the imposition of penalties on lenders would discourage some potential loan providers from participating in the bid process. Similarly, the concept of policing lender behavior raises serious questions about the extent of additional regulatory burdens and reporting requirements that would be placed on lenders.

7) **Stipulations for loan terms and servicing standards.** An auction that focuses strictly on price could sacrifice future product and service enhancements and, at same time, erode current quality standards. An approach that considers servicing standards would certainly complicate the auction process, and such restrictions could be designed to eliminate certain potential bidders. Small lenders, which can't afford the cost of submitting complicated bids, may withdraw.

   One possible solution to this problem is to pre-qualify bidders to assure that certain servicing standards will be met. This idea could help assure initial quality but would provide no guarantee that quality would be maintained over the long run. Similarly, issues are raised regarding that sale of loans to other holders. Would the Department of Education also have to qualify these third parties to hold loans?

8) **Restrictions on loan servicing arrangements.** To minimize disruptions to borrowers and schools, auction advocates have suggested several ways to maintain continuity of loan servicing. For example, winning bidders could be required to use loan servicers selected by schools or borrowers. This would address serial borrowing needs but may not be viewed as practical from the lenders' point of view. Some lenders could be barred from servicing their loans in-house, while others could face limited options for selling loans to secondary markets. Moreover, allowing schools to stipulate servicers would put lenders at an inherent disadvantage in negotiating servicing contracts.

9) **Restrictions on bidders.** Allocating a major share of loan origination rights to a lender that ultimately lacked the capacity to deliver could prove catastrophic for schools and students who must have the loan funds at enrollment time. To address this problem, bidders could be required to demonstrate they have the financial resources and delivery system to supply their allocated loan volume. This is a standard practice in many rights auctions; however, it would further complicate the evaluation process, and bidding standards could be manipulated to favor existing program participants over potential new capital providers. This approach would most likely impose new federal oversight and reporting requirements.

10) **The bidding process.** Loan rights could be awarded after a single round of sealed bids or a multi-stage bidding process. Several rounds of bidding could establish the lowest price needed to keep a sufficient number of lenders in the program to meet borrowers' needs. Elimination-round bidding, however, would be complicated and time consuming and would probably favor bigger players.

Features of a Loan Auction

By all accounts, an auction of loans already made by the Department of Education would be, from the standpoint of auction administration, simpler than an auction of the right to make loans. This section briefly discusses possible features of a loan auction and the

potential impact on how students and schools participate in the student loan programs. Like the discussion of rights auctions above, this list is not comprehensive, but it does address the central issues.

1) **How loans would be sold.** In a loan auction, the government may sell loans it holds directly, or it may bundle portfolios of loans and auction them as asset-backed securities. This latter approach would be similar to a financing mechanism now widely used in the guaranteed student loan program.

   If loans are sold directly, the price received on the loans will depend in large measure on the types of loans sold. For this reason, the packaging of loans for sale would be a critical step in managing loan sales. Factors such as the probability of default and the average account balance would result in a higher or lower bid price of loans. These factors would also be taken into account by bidders if loans were sold via asset-backed securities.

2) **Guarantee vs. no guarantee.** Loans sold by the government may or may not carry a guarantee against the borrower's default, disability, or death. If a guarantee is offered, a key decision will be whether that guarantee would be issued by the Department of Education itself (as it did under the now-defunct Federal Insured Student Loan Program) or by an existing FFELP guarantor.

   The price received by the government for auctioned loans would be much higher in the case of loans subject to a guarantee than in the case of loans not subject to a guarantee. If the borrower defaulted, the loss would fall to the holder instead of a guarantor or the federal government.

3) **When loans would be sold.** To assure that all loans made to an individual borrower are held by a single holder or serviced as a single account, loans are unlikely to be sold until the borrower has completed his or her educational career. This means that the Department of Education would hold very large volumes of student loans during the in-school period. The Department would also have to service these loans, ostensibly in much the same way as Federal Direct Loans are serviced.

4) **Pricing.** Bidding could be based on the characteristics of loans included in the lot offered for sale. Because the bids will differ significantly based on a portfolio's loan mix, some sectors of higher education could pressure the Department of Education to make sure that all lots offered for sale are representative of the entire national portfolio of loans.

5) **Frequency of auctions.** The timing of auctions will be set in large measure by the Department's determination of the impact on the prices received for lots of loans offered. Frequent—and thus smallXloan offerings could discourage some potential bidders. In contrast, infrequent auctions could also discourage widespread participation. Auctions would be held periodically, with at least one auction per year, depending on the volume of loans available for sale. Because it is unlikely that loans would be sold while borrowers are in school, initial sales of loans may involve portfolios of loans to students who attended shorter-term courses of study. These initial loan sales would not be typical of subsequent sales, which would include a larger volume of loans issued to students with multiple years of postsecondary education.

6) **Qualification of bidders.** If loans are sold as asset-backed securities or are subject to life-of-the-loan servicing arrangements set by the Department of Education, bidders would not have to possess any special expertise in managing student loans. If successful bidders are granted the right to service their purchased loan portfolios, the Department would be likely to pre-qualify bidders to assure that loans would be serviced in the best interests of borrowers. Such pre-qualification would be especially important if loans are sold without federally supported guarantees or insurance.

7) **Impact on customer service.** A major concern relates to the quality of customer service as experienced by students and schools. It is obviously impossible to know just how customer service would change, but current incentives on the part of guaranteed student loan providers to provide quality service to students and schools would be decreased in a loan auction. Bidding in such an auction is likely to take place years after the promissory notes are signed, rendering excellence in service as largely irrelevant to securing loan volume. Moreover, this approach is not likely to provide the incentives needed to ensure quality servicing of loans in repayment. If this analysis is correct, service quality will deteriorate. This is not just an issue of convenience for borrowers and schools. Erosion of service quality means less effective communication with borrowers and thus increased chance of repayment problems. The key to effective default prevention is staying in touch with borrowers.

8) **Auction of the existing Federal Direct Loan portfolio.** Some advocates of student loan auctions have suggested that an auction would provide an opportunity to "merge" the current FFELP and the Federal Direct Loan Program into a single program. If such an approach were taken, a loan auction may include sale of the entire outstanding portfolio of the Federal Direct Loan Program. This portfolio currently consists of more than $45 billion in outstanding loans, a growing percentage of which are in repayment.

Long-Term Implications of a Student Loan Auction

In theory, an auction process could help lower the cost of federal education loans over the short term. Over time, however, an auction approach is likely to reduce the number of market participants, since losing bidders are unlikely to remain in the student loan business. Based on the HEAL experience, an auction process is unlikely to meet the needs of schools.

A decline in the number of market players could eventually reduce the competitiveness of the auction. Fewer players mean bigger players, raising the costs and stakes of trying to enter or re-enter the market. As the number of bidders dwindles, so does the pressure to hold the line on costs and lender-yield requirements. The remaining bidders would have little incentive to improve service quality or invest in new technologies. Without assurances that they will "win" an auction, lenders will have no incentive to make long-term investments in loan origination or servicing systems. Lenders simply cannot assume that they would fully recoup the cost of such investments. Eventually, borrowers could pay higher rates and taxpayers could fund bigger subsidies for stagnating service levels.

Moreover, auctions will create disruptions in the student loan delivery system. Losing bidders could be abruptly forced out of the program. Such dislocations force borrowers and schools to locate new sources of funds and split borrowers' loan portfolios among multiple loan holders and servicers. Such changes would be the result of shifting lender relationships rather than innovation. Although measures could be implemented to

increase the number of bidders or enhance loan terms, such steps tend to increase program costs and complexity and thus undercut the benefits of an auction pricing system.

Is the Current Federal Family Education Loan Program "Market-Based"?

Most advocates of student loan auctions contend that the current guaranteed loan program is not "market-based." They argue that only an auction would establish a truly fair price for the government to pay as a means of inducing lenders to make loans. Critics suggest that the current approach, which sets returns to lenders under a formula specified in the Higher Education Act, overpays lenders and thus is not "market-based."

To determine whether the FFELP is market-based, it is useful to look at the two basic ways lenders compete in the student loan marketplace today: price and service. By most accounts, lender competition based on service became fierce in the late 1980s, well before the enactment of the Federal Direct Loan Program in 1993. During this period, FFELP loan providers developed and implemented continuous improvements in loan delivery systems and servicing standards, notwithstanding the absence of any federal requirement to do so. For example, millions of dollars have been invested in sophisticated automated account inquiry services borrowers can access via telephone or the Internet. The Web sites of lenders, loan servicers and guarantors offer dozens of calculators and other interactive counseling resources. Over the last five years, lenders intensified their efforts to win customers by increasing the focus on price. Today, competition based on the cost of loans to borrowers is virtually universal. Clearly, students and parent borrowers are the primary beneficiaries of these free-market initiatives, and a recent government survey shows that the guaranteed loan program is enjoying strong gains in customer satisfaction among schools and borrowers.[8]

The competition in the FFELP offers a sharp contrast to the competition-attrition risk posed by virtually every proposed auction model. Over the long-term, it is virtually certain that auctions will ultimately reduce price competition among loan providers. Similarly, if use of an auction mechanism works as assumed by many of its advocates, government payments to lenders could be substantially reduced. Because an auction will diminish the competitive necessity of appealing to borrowers and schools on the basis of service, investments in customer service are likely to decline. Borrowers will face lower standards of service and any incentive to invest in new technologies will be eliminated.

Conclusion: Auctions May *Not* Be in the Best Interest of Students and Schools

Most discussions of student loan auctions assume that the federal government, probably the U.S. Department of Education, would auction the right to make student loans or loans already made by the federal government. In both cases, a new intermediary—the auctioneer—is placed between loan providers and borrowers.

This shifting dynamic will dilute market forces at work in the program. Under an auction model, competition on service would be sidelined entirely, and competition on price would be reduced, because there would be fewer players.

Ironically, another implication of an auction could be a dramatic increase in the federal government's role in the student loan delivery system. For an auction to work properly,

[8] "Direct Loan Program Administration, 1993-1998," Macro International, under contract to the U.S. Department of Education.

bidders will have to be pre-qualified, and complicated rules relating to evaluating bids will have to be developed. Under a rights auction model, the Department of Education would face the task of determining whether to establish a secondary market in auction rights and how such a market would be regulated. Moreover, federal employees would have to police lenders to confirm they were not "skimming" the lowest risk borrowers or otherwise failing to serve all parts of the student loan market.

In general, the myriad questions voiced regarding the structure and outcomes of student loan auctions focus on how to protect the interests of borrowers and taxpayers, while fostering competition. Policymakers can choose among dozens of alternative auction concepts for structuring the bidding process, including models designed to satisfy school concerns about retaining lender choice. Still, in many instances, addressing auction implementation issues would require the development of special rules and procedures or the creation of a management/oversight function within the Department of Education. As policymakers and Congress consider the issues, they should ask whether the negatives associated with an auctionXincreased complexity, abrupt changes in loan providers, a heavier regulatory burden, and eventual deterioration in service levelsXoutweigh the benefits.

Thus, any serious consideration of "market-based mechanisms" must start with a disciplined examination of the policy goals that underpin the federal student loan programs. The study group should not only evaluate new market-mechanisms against these objectives, but should also assess the current guaranteed loan program's track record in achieving national policy goals. This discovery process might well demonstrate that more could be lost than gained by adopting an auction system that radically alters the diverse incentive structure that currently drives FFELP loan providers to serve all eligible borrowers at ever-increasing levels of service and price benefits.

Questions about Auctions

The short overview of auctions presented in this paper does not begin to exhaust the questions the market mechanisms study must address. The following are some of the questions identified to date for the study group to consider:

Fundamental questions

Would borrower access to student loans be affected by an auction?

Would borrowers pay more, less, or the same for loans?

Would modernization of the student aid delivery system be supported or undermined?

Questions relating to the role of institutions

Would the current role of schools in screening loan providers be changed? If so, how?

Would a school lose the ability to work with a preferred loan provider?

Would loan providers' attention to the needs of schools be diminished?

Could an auction indirectly lead to lower servicing quality and higher institutional default rates?

Would institutions lose the ability to shop for lower rates for borrowers?

Questions relating to borrowers

Would borrowers lose their ability to choose a loan provider?

What options would the borrower have if the loan provider's service quality proved unsatisfactory?

Would an auction mechanism eliminate price discounting now in effect in the FFELP program?

Would an auction reduce borrower cost of loans?

Would an auction result in lower service quality by discouraging long-term investments in technology?

Would an auction discourage providers from being attentive to borrowers?

Would borrowers still be able to obtain all of their loans from a single loan provider or have all of their loans placed with a single loan servicer?

Questions for the federal government

What federal agency should run the auction?

Would the cost of the student loan program increase or decrease?

What new administrative personnel and structure would be necessary to run the auction and conduct related program oversight?

Would default risk be increased or decreased?

Would an auction necessitate an enhanced lender of last resort program?

Is the risk of a catastrophic program failure, such as the inability of the system to make loans in a timely fashion, increased?

Is the opportunity for fraud and abuse increased?

Questions for loan providers

Would loan providers be able to predict their volume of loan business from year to year?

What incentives would remain for high levels of customer service?

Would all current loan providers have a fair opportunity to participate in the auction process?

What new regulations and reporting requirements may be established?

How would unused auction rights be handled?

What options would the lender have with regard to servicing loans?

If non-quantitative criteria were included in the auction, would the auction administrator be able to evaluate such criteria?

Would entities with no prior experience in student loans be authorized to participate in the auction?

Would entities be authorized to sell unused rights or purchase rights from others?

Student Loan Auctions: Issues and Implications

A Brief History of Student Loan Interest Rates

Since the inception of the federal education loan program in 1965, Congress has orchestrated a series of changes in the interest rates charged to borrowers and the rates paid to lenders.

The original Government Student Loans (GSLs) carried a fixed, annual interest rate of 6 percent. Over the next 25 years, rates on GSLs, which were renamed Stafford loans in 1988, were adjusted periodically to reflect the upward trend in interest rates that accompanied the inflation of the 1970s and early 1980s. During the first 27 years of the program, Stafford loans continued to charge fixed rates. Although the repayment rates for loans issued to first-time borrowers eventually rose to 10 percent, some borrowers continued to pay rates of 6 or 7 percent, because federal rules capped their interest rates at the rate charged by their initial Stafford loans.

Variable rates were introduced for Supplemental Loans for Students (SLS loans) and PLUS loans in 1986, but Stafford rates remained fixed until the early 1990s. Over a two-year period, Congress approved three pieces of legislation that swiftly converted both new and existing Stafford loans to a variable-rate structure. The conversion began under the Higher Education Amendments of 1992 and continued under the Student Loan Reform Act of 1993 and the Higher Education Technical Amendments of 1993. These changes are summarized in the accompanying table.

The first variable-rate formula—the 91-day Treasury Bill rate plus 3.1 percentage points—applied only to "new" borrowers—those who had no outstanding Stafford balances on or after October 1, 1992. Beginning July 1, 1994, all new Stafford loans carried variable rates, adjusted each July, regardless of the student's status as an "old" or "new" borrower. To protect borrowers, these new Stafford variable rates were capped at 8.25 percent. The legislative changes also required lenders to convert a large number of fixed-rate Stafford loans to the variable rate. This action ensured that existing borrowers benefited from downward trends in interest rates. In addition, Congress established a two-tier rate system for Stafford loans issued on or after 1995. Under this system, borrowers who are paying back their loans pay higher interest rates than other borrowers. The borrowers who pay lower rates are as follows: borrowers still in school; borrowers who are in the six-month, post-school grace period; and borrowers in an authorized period of deferment.

In 1994, the Department of Education established its Federal Direct Consolidation loan as a variable-rate loan, even though the rules required a fixed rate for guaranteed Federal Consolidation loans. Emergency legislation enacted in November 1997 sought to alleviate a large backlog of unprocessed consolidation applications submitted to the Federal Direct Loan Program by allowing private lenders to consolidate direct loans. This legislation also established a variable rate for guaranteed Federal Consolidation loans, using the same formula in effect for direct loans.

Congress initially established the three-month Treasury bill rate as the index, or base rate, for Stafford and other variable-rate federal education loans. However, the 1993 Student Loan Reform Act scheduled a change in the formula to take effect July 1, 1998. This change called for switching the index to a loosely defined government debt instrument, which was generally interpreted to be 10-year Treasury bonds.

Federal education lenders and secondary markets soon realized that the 1998 formula was untenable. Lenders and loan holders finance their student loan portfolios with financial instruments tied to short-term interest rates. Tying the interest rate paid on these loans to a long-term interest index would increase financing risks and thus the cost of raising the money to fund new student loans. Many industry observers argued that virtually all private lenders would be forced to withdraw from the FFELP program within a few years, if the rate change scheduled for July 1, 1998, was allowed to take effect.

The controversy triggered a series of studies, and officials at the Department of Education and the Treasury Department eventually acknowledged that the new rate formula would not work. FFELP loans are the single largest source of financial aid to students, and many schools began to worry about the availability of Stafford loans for the 1998-99 academic year.

Correcting the problem proved difficult, because the school community and members of Congress wanted to preserve the interest rate reduction that would have gone into effect, at least for the 1998-99 year, under the 10-year T-bond formula. This rate reduction reflected an extreme flattening of the yield curve in late 1997 and early 1998. At that time, the yields on Treasury bonds hovered only 50 basis points above the three-month Treasury bill rate.

Working with members of the financial aid community, Congress eventually worked out a compromise plan that retained the three-month T-bill rate as the variable-rate index for Stafford and other federal education loans. The compromise, however, increased the complexity of the interest rate structure for education loans. The new legislation set different formulas for the rate paid by borrowers and the rate received by lenders.

The 1998 rate legislation also included provisions governing interest rates for federal consolidation loans. These provisions emphasized congressional intent to standardize key loan terms such as the maximum interest rate* for direct and guaranteed consolidation loans. The new law set the consolidation rate at the weighted-average interest rate for the loans being consolidated rounded up to the nearest one-eighth of 1 percent. This rate became effective for guaranteed consolidation loans on October 1, 1998, and for direct consolidation loans on February 1, 1999. The rate formulas enacted in 1998 are scheduled to remain in effect until 2003.

The accompanying table illustrates the effect of legislative changes and shifting interest rates on the cost of federal education loans over the past 34 years.

* Under federal law, the rate formulas for guaranteed loans set the maximum rate lenders may charge. Lenders may charge lower rates.

GUARANTEED STUDENT LOAN INTEREST RATES FOR Stafford BORROWERS 1965-2003[9]

Effective Years	Rate Type	Interest Rate[10]		Formula
1965 - 1967	Fixed	6%		---
1968 - 1979	Fixed	7%		---
1980 - 1987	Fixed	9%		---
1988 - 1992	Fixed	8% - 10%		8% during the in-school, grace and deferment periods and the first four years of repayment; 10% during the remainder of the repayment period.
1992 - 1994	Variable	1992-93: 6.94% 1993-94: 6.22%		Adjusted annually on July 1, based on 91-day T-bill plus 3.1%, capped at 9%.
1994 - 1995	Variable	1994-95: 7.43%		Adjusted annually on July 1, based on 91-day T-bill plus 3.1%, capped at 8.25%.
		In-School Rate	**Repayment Rate**	
1995 - 1998	Variable	1995-96: 8.25% 1996-97: 7.66% 1997-98: 7.66%	1995-96: 8.25% 1996-97: 8.25% 1997-98: 8.25%	Adjusted annually on July 1, based on 91-day T-bill plus 2.5% during in-school, grace and deferment periods. Repayment rate is 91-day T-bill plus 3.1%. Capped at 8.25%.
1998 - 2003	Variable	1998-99: 6.86% 1999-00: 6.32%	1998-99: 7.46% 1999-00: 6.92%	Adjusted annually on July 1, based on 91-day T-bill plus 1.7% during in-school, grace and deferment periods. Repayment rate is 91-day T-bill plus 2.3%. Capped at 8.25%.

[9] Source: Higher Education Act of 1965, as amended, and U.S. Department of Education.
[10] For borrowers with no previous federal student loans.